

17 MAY 1984

MEMORANDUM FOR: Deputy Director of Personnel for Special Programs

Deputy Director of Personnel for Policy, Analysis, and Evaluations

STAT FROM:

Liaison Division  
Office of Legislative Liaison

SUBJECT: Supplemental Retirement Articles in the Federal Times

1. Attached for your information and use is a consolidated Congressional Record reprint of the seven articles recently written for the Federal Times by Mr. Jamie Cowen, Special Counsel for the Subcommittee on Civil Service, Post Office, and General Services (chaired by Senator Ted Stevens, R., AK) of the Senate Committee on Governmental Affairs.

2. If members of your staff feel that they would benefit from a first hand discussion of these issues with Mr. Cowen, I would be glad to attempt to set up such a session.

STAT  
  
Attachment:  
As stated

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# Ted Stevens

## United States Senator For Alaska



United States  
of America

# Congressional Record

PROCEEDINGS AND DEBATES OF THE 98<sup>th</sup> CONGRESS, SECOND SESSION

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## Senate

### A NEW CIVIL SERVICE RETIREMENT PROGRAM

Mr. STEVENS. Madam President, one of the major issues to confront the 99th Congress will be the design of a new civil service retirement program. The Subcommittee on Civil Service, Post Office and General Services, which I chair, has been sponsoring pension policy forums and studies to help draft such a new plan. The subcommittee's special counsel, Jamie Cowen, has just completed a series of articles for the Federal Times which examines the issues to be considered in designing a new civil service pension plan. I ask unanimous consent that the series of articles be printed in the RECORD.

There being no objection, the articles were ordered to be printed in the RECORD, as follows:

#### DESIGNING A NEW RETIREMENT SYSTEM (By James S. Cowen)

With passage of the Social Security Amendments of 1983, all federal employees hired after December 1983 will be covered by both the social security system and the civil service retirement system.

Establishing a new civil service retirement plan is necessary to coordinate the two systems and reduce the excessive contributions and benefits they provide for.

Under special legislation introduced by Sen. Ted Stevens, R-Alaska, and passed in the waning days of the last session of Congress, employees hired after December 1983 will contribute to the civil service system at a reduced rate until December 1985 or the establishment of a new retirement program, whichever is earlier. Congress will be considering proposals to establish a new plan immediately after the 1984 elections.

Now is the time to influence the design of a new retirement plan coordinated with social security, and the federal community must get involved at the ground level in the design work. It must study the particulars of the pension field and then tell Congress what is desired.

This article and others to follow will try to give a basic framework for understanding pensions. We'll be looking at the importance of a new plan to the current work force, the objectives of a retirement plan, social security and how to coordinate it with a new plan, the major features and basic structure of retirement plans and, finally, the financing and costs associated with such plans.

Why is a new plan important to all federal workers?

The obvious answer to this question is: to preserve the continued solvency and benefit structure of the current plan. The advent of a new system, however, will have little or no impact on the solvency of the current system.

The current system's financial condition does not depend upon new entrants. Its soundness is secured solely by continued government appropriations into the retirement trust fund. Whether or not a new plan is linked to the current one has little to do with the sufficiency of the trust fund.

But the overall level of benefits provided in the new plan may affect the current

plan's benefit structure. If the new plan is substantially less generous than the current one, pressure may mount to pare the benefit levels in the current plan.

The fear that a social security-based plan will be forced on current workers is probably unfounded. There appears to be little support in Congress for such a move. Typically, companies and state governments establishing new plans grandfather current workers into existing ones. Concern should focus on mounting pressures to reduce the benefits of the current program.

A second reason for interest is the impact a new plan will have on the makeup of the future federal work force.

Retirement plans drive the demographics of a work force. Generous benefits for primarily long-career employees will attract individuals who want to spend their working life in government. Benefits for short-term workers will appeal to those who want career flexibility.

Retirement ages affect upward mobility in the work force and retention of expertise. What's beneficial to a government executive may not be to a carpenter. Because the current work force understands the benefits and shortcomings of the current retirement program, it can assist in the development of a new plan and, hence, a future work force.

Finally, many in the work force may have concluded that the current retirement plan does not adequately serve their own career and retirement plans. The current system primarily benefits individuals who retire at earliest eligibility. For those who leave government before retirement, it falls miserably.

In such a situation one may withdraw contributions at little or no interest, or leave the money in the system and defer receiving an annuity until age 62. Since the annuity is not indexed for inflation until retirement, deferring it until age 62 often results in the real benefit being significantly diminished.

Employees who work well beyond retirement age fare better in many private sector plans. Social security serves as the basis for private plans. It provides a full benefit at age 65 and a reduced one at 62. Many who retire at social security eligibility in the private sector would find that the combined benefits of social security and their private pensions exceed that of a federal employee retiring at the same age.

These federal employees may find that a new plan serves them better. Thus, they should ensure an attractive option exists to transfer to the new plan.

Normally, such arrangements exist in two forms.

An employee's benefits accrued up to the point of transfer are frozen, with the understanding that service in the new plan be counted for purposes of eligibility for retirement in the old plan.

An employee's service is simply transferred to the new plan and the option is sweetened with an incentive such as a refund of old-plan contributions with interest.

The point is that current federal employees should take an active role in developing the new plan. They have a unique perspective and possibly have the most to gain from such involvement.

The primary purpose of a retirement plan is to provide employees with a comfortable transition from a working career to retirement.

This doesn't mean the retiree must receive a benefit equal to 100 percent of his pre-retirement salary. Many costs borne by the working population are not applicable to retirees. For them, mortgages are often fully repaid, children are gone, work-related expenses no longer exist and favorable tax treatment of the elderly applies.

Most experts agree that to maintain the standard of living for a low income worker, benefits equal to 70 to 80 percent of pre-retirement salary are necessary. For a high income employee, the amount suggested is 55 to 60 percent. This means that ideally the combined benefit of social security and the employer's pension for a career employee should equal those amounts.

From an employer's perspective, retirement should be encouraged at the point where the employer would benefit by replacing the older worker with a younger one. This point can vary greatly depending upon the type of job. For instance, employees in white collar jobs generally can work longer than those employed in blue collar positions. Thus an employer may vary retirement eligibility depending upon the type of work involved.

If an employer desires long-term employees with minimal turnover, the plan should provide for late vesting with generous benefits at a specified retirement age.

The plan's formula should be tilted to reward long-term employees as the civil service retirement system currently does. A compensation system tilted away from pay but toward rich retirement benefits will also encourage long-term employment.

If an employer prefers a certain amount of turnover, possibly an early withdrawal feature, common in thrift plans, could be made available to employees. If mid- or late-career recruitment is wanted, then a formula weighted toward early years of service and based on some final salary arrangement could be employed. Obviously, the richer or more costly the package the more successful the employer will be in recruiting and retaining desired personnel.

A retirement plan is only one part of an employer's compensation package, but it clearly will influence the work force's make up. Thus, before designing a new retirement plan for the government, decisions must be made as to the desired characteristics of a future federal work force.

#### COMBINING PENSION PLANS: WHAT'S BEST? (By James S. Cowen)

The social security system and the civil service retirement system differ in the types of benefits provided, when they are provided and how they are provided. In fact, their goals also differ.

Social security is, in part, a social insurance program that redistributes wealth from high to low-income workers. Civil service retirement, on the other hand, is a staff retirement plan which replaces a certain percentage of an employee's pre-retirement earnings at all income levels.

Social security attempts to provide a safety net for the elderly. Civil service retirement, in a sense, defers wages.

Coordination of the two programs, however, is readily feasible. Private firms, for example, often coordinate their pension programs with social security.

## SOCIAL SECURITY

The basic benefit of social security is the old-age benefit. This is based on average career wages adjusted for inflation.

An eligible beneficiary can begin drawing a full old-age benefit at age 65 (this will increase gradually to ages 66 and 67 after the year 2009) and a reduced one at age 62. Workers become eligible for an old-age benefit if they work in covered employment the lesser of 10 years (40 quarters) or one quarter for every year after 1950 and before age 62.

A spouse of an eligible beneficiary is entitled to an additional 50 percent of the basic benefit upon reaching age 65. Survivor benefits are also available to spouses upon attaining age 60 or age 50 if disabled or any age if the spouse has dependent children.

The elderly spouse is entitled to 100 percent of the worker's basic benefit. The younger spouse and dependent children are entitled to 75 percent of the worker's benefit. Generally, survivors are eligible for benefits if the worker had 18 months (six quarters) of covered employment.

Finally, disability benefits are available to the covered worker and his family if the worker is ruled totally disabled and unfit for substantial gainful employment for one year or longer. Such workers are entitled to 100 percent of the basic benefit.

An elderly spouse or one with dependent children is eligible for an additional 50 percent for each person subject to a maximum family benefit. To be eligible for a disability benefit, the worker must have had five years (20 quarters) of covered employment, less if the worker is younger than age 31.

Social security benefits are skewed to the low-income worker, while civil service benefits replace the same percentage of salary at all income levels.

Assume employees A, B, and C work for three years and retire at different salary levels. Table I is a rough example of the basic benefits provided under both programs and their replacement of final salary for the three employees.

TABLE I<sup>1</sup>

| Employee                | A        | B        | C        |
|-------------------------|----------|----------|----------|
| Final year's salary     | \$15,000 | \$30,000 | \$45,000 |
| Social security benefit | \$6,000  | \$8,200  | \$8,400  |
| in percent              | 40       | 27       | 19       |
| Civil service benefit   | \$8,000  | \$16,000 | \$24,300 |
| in percent              | 54       | 54       | 54       |

<sup>1</sup> Ed Husted, Hay Associates.

While under both programs the high-income worker receives a larger benefit than the low-income worker, the low-income worker receives proportionately a much greater percentage of final salary under social security.

The question becomes how to coordinate a new civil service plan with social security to achieve reasonable replacements of salary as well as normal employer goals such as desired work force characteristics, competitiveness with other employers, high or low employee turnover, and the rewarding of long-term employees.

## A NEW PLAN

Retirement benefits are normally viewed as deferred compensation and, hence, bear a direct relationship to earnings. Social security's policy of redistributing wealth to low-income workers conflicts with the underlying policy of many pension programs.

There are ways for employers to deal with this problem. They can implicitly recognize the value of social security to the employee by granting a pension which when coupled with social security provides a reasonable retirement income.

Table II is such an example using the same assumptions as Table I.

TABLE II<sup>1</sup>

| Employee                                    | A        | B        | C        |
|---|----------|----------|----------|
| Final year's salary                         | \$15,000 | \$30,000 | \$45,000 |
| Social security benefit                     | \$6,000  | \$8,200  | \$8,400  |
| Pension benefit (1.5 percent times service) | \$5,100  | \$12,200 | \$18,200 |
| Total income                                | \$12,100 | \$20,400 | \$26,600 |
| in percent                                  | 80       | 68       | 59       |

<sup>1</sup> Ed Husted, Hay Associates.

Note in this example that the pension benefit—1.5 percent times service—is less than the current program. Yet, in most cases, it provides greater income than the current civil service system when coupled with social security.

Also note that the large redistributive nature of the social security program is retained, thereby proportionately benefiting those with lower income.

The Internal Revenue Code permits an employer's pension formula to substantially reverse or explicitly recognize the tilt in social security in order to level the percentage of pre-retirement earnings, replaced in the overall retirement benefit.

In Table III, for example, the pension benefit is reduced by one-half of the amount of the social security benefit:

TABLE III<sup>1</sup>

| Employee   | A        | B        | C        |
|--|----------|----------|----------|
| Final year's salary  | \$15,000 | \$30,000 | \$45,000 |
| Social security benefit                                    | \$6,000  | \$8,200  | \$8,400  |
| Pension benefit (gross benefits (2 percent times service)) | \$8,100  | \$16,200 | \$24,300 |
| Half social security benefit                               | \$3,000  | \$4,100  | \$4,200  |
| Net benefit  | \$5,100  | \$12,100 | \$20,100 |
| Total income (pension and social security)                 | \$11,100 | \$20,300 | \$28,500 |
| in percent   | 74       | 68       | 63       |

<sup>1</sup> Ed Husted, Hay Associates.

Note that while Employee C is still receiving a lower percentage of his final salary than Employee A, the difference is not as great as the example shown in Table II. Employees, in effect, are being treated in a more consistent fashion at all income levels.

Many state governments use formulas similar to that shown in Table II. Most private employers, however, use some variation of the integrated method shown in Table III. This issue can be very significant.

Should the government adjust for the redistributive formula in social security, or should it keep that till in the new plan?

Additionally, depending upon the plan's structure, if the pension plan permits retirement before social security eligibility, pension benefits may be relatively small until receipt of social security benefits.

Some private plans offer what is termed a leveling option in which the employee receives a larger portion of his pension benefit in the years prior to social security eligibility. When social security payments begin, the pension is substantially reduced to maintain the same total income as prior to the commencement of social security.

Irrespective of how coordination with social security is accomplished, the result will significantly affect the total retirement package for the federal government.

Thought must be given to how the new plan will meld with social security in providing basic benefits as well as survivor and disability benefits.

In many cases, social security survivor benefits exceed current civil service benefits. Should there be a dollar-for-dollar offset from the two plans?

Additionally, social security disability benefits are fairly generous but eligibility is very restrictive. So, many private firms provide a separate disability program with far less stringent eligibility requirements than social security.

Currently, disability retirements account for 15 to 20 percent of government retirements. Proper coordination with social security is vital to a complete retirement plan.

## DIFFERENT PLANS PRESENT A CRUCIAL CHOICE

(By James S. Cowen)

Both the social security and civil service retirement systems are known as defined benefit plans. Both systems promise a certain benefit calculated as a percentage of salary and in some measure are dependent upon length of service.

There is another common type of retirement plan: the defined contribution plan. In this case, the employer, and occasionally the employee as well, contributes a specified percentage of salary to an employee trust fund account. The money is then invested in various types of interest-bearing instruments. The employee's retirement benefit consists of the contributions in his account plus their accumulated earnings.

In such a case, an arrangement is normally made with the retiring employee to transform his or her account into a lifetime annuity. The amount of the annuity is determined by the employee's projected mortality, the amount of money currently in the employee's account, and the returns the account is expected to earn while being disbursed.

Both types of plans, defined benefit and defined contribution, have their advantages and disadvantages. The decision as to which plan will serve as the new civil service pension is probably the most significant issue facing the federal work force.

Defined benefit plans are more prevalent in older, unionized industries. In recent years, however, defined contribution plans have been used more frequently. This can be attributed to difficult economic times and to the fewer legal requirements imposed on employers who use contribution plans.

The most consequential difference between a benefit and a contribution plan is the certainty of the benefit. A defined benefit plan promises a specific benefit regardless of the economic climate. Poor economic conditions do not affect that benefit, especially if it is adjusted for inflation, as in the civil service retirement system. In a sense, the government bears the risks and costs of an inflation-adjusted benefit plan.

An important caveat to this is the assumption that an employer will not reduce the

level of benefits under a defined benefit plan during an economic slump. The Employee Retirement Income Security Act, which regulates private pensions, prohibits reductions in accrued benefits once employees are vested.

But ERISA does not cover the civil service retirement system, and thus changes are not prohibited. Congress has reduced benefit levels often in recent years. In fact, it is unlikely a government benefit plan can ever be fully insulated from subsequent acts of Congress.

In a contribution plan, the employee owns the account and thus bears the economic risk. If investments do well, the employee's account gains. The reverse is equally true.

Rather than providing for a certain benefit, a contribution plan assures a certain cost—an advantage for the employer. But a well invested contribution plan can provide employees with good benefits while not increasing employer costs.

The employee's certainty in a defined contribution plan is in owning the account. Normally, annual statements are provided to the employees showing their accumulations. These statements keep the employees involved in their own retirement planning and assist them in determining when to retire.

A more esoteric and yet perhaps more crucial point concerns congressional power over the plan. If federal employees owned their accounts, Congress could not reduce them. While Congress could change future contributions, it would be prohibited from tampering with the current accounts and funds. In such a case, a contribution plan would be more secure than a benefit plan.

In most situations, however, the defined benefit plan provides certainty for the employee while the defined contribution plan provides the same for the employer.

The greatest advantage of a contribution plan is its portability.

Because an employee owns his account, most plans permit the employee to take his account with him if he leaves the organization. This allows the employee to roll over the accrued funds into an IRA or the subsequent employer's pension system, so the funds can continue to grow.

In other words, the employee loses nothing by changing jobs. This allows a great deal of flexibility in career planning.

Most benefit plans in effect penalize less than full-career employees. A departing employee rarely can take any benefits with him. Instead, if he is vested, he is entitled to receive the benefit at retirement age. In most cases, however, benefits are not adjusted for inflation after the employee leaves, at least not until he begins receiving them. Thus, the real level of the benefit will be greatly reduced.

Another important factor is the entry age of an employee into the plan.

A contribution plan is more advantageous for a worker starting a job while relatively young. This gives his account time to accumulate contributions and take advantage of compounding interest.

For example, an early participant in the Teacher's Insurance and Annuity Association and College Retirement Equities Fund, the nation's largest defined contribution plan, would have seen his 1952 stock unit valued at \$10.50 increase to \$140 today when the compounding effect is considered.

The defined benefit plan is better for a middle-aged worker taking a new job. As noted above, the employee will receive a specified benefit not dependent upon accumulated contributions.

Obviously, the contribution plan account of an older-entry employee will not have sufficient time to fully accumulate unless the employee is permitted to roll over a cashed-out account of another plan into his present one. Also, a benefit plan is far more adaptable to crediting past service than a contribution plan.

For employees who plan to work beyond retirement age, the contribution plan may be more attractive. While benefits increase under both types of plans as one works longer, the rate of increase under a contribution plan accelerates in later years due to compounding.

Finally, which plan better hedges against inflation after retirement will depend upon the extent of the cost-of-living adjustment available in a defined benefit plan. A contribution plan can protect against inflation after retirement. Even while being disbursed through an annuity, funds in a contribution plan are being reinvested. Thus, the money earned by the disbursing account can provide inflationary protection.

Very few defined benefit plans in the private sector incorporate automatic COLAs. Those that do cap the adjustments at 3 or 4 percent. Most companies will provide COLAs on an ad hoc basis depending on a company's ability to pay for them.

But the lack of any regular adjustment for employees in private plans must be seen in light of the fact that these same employees receive social security benefits, which

are adjusted for inflation.

The defined benefit plan, if it includes a COLA comparable to that provided in the civil service retirement system, would clearly be preferable. But the cost of the full, automatic COLAs now applied to federal retirement programs is one of the budgetary items most under attack. It may be very difficult to establish a new pension system with that feature given the current economic climate.

Private industry often provides a combination of the two plans for its employees. Most firms offer a defined benefit plan as the basic pension. Yet many also offer a supplemental contribution plan such as a thrift, salary reduction, stock option or profit-sharing plan.

The two plans together meet the objectives of many employees by providing the security inherent in a defined benefit plan with the portability attached to a defined contribution plan. A refined mixture of the two plans can make for a very attractive retirement program.

#### HOW RETIREMENT ELIGIBILITY CAN AFFECT WORK FORCE

(By James S. Cowen)

Employer objectives must be carefully considered before the actual design of a retirement program.

The earlier the retirement age, the greater the potential for young employees to move up as older employees retire. This has been true with the federal government.

Additionally, an employer's major concern is to encourage retirement at the point where the employer would benefit from retiring the older worker and replacing him with a younger one.

When this point is reached depends in large part upon the position involved. Jobs requiring physical stress or labor may require a fairly early retirement age. Later retirement ages should be considered for those in white collar jobs.

But if the employer wants long-term employees—including white collar ones—an early retirement age with a substantial service requirement should be provided.

An early retirement age, however, may cause a loss of expertise by spurring senior employees to retire early. A recent phenomenon in the civil service is a case in point. Retirees were getting full inflation-adjusted benefits while active employees saw their pay capped or restrained, thus creating an economic incentive for senior employees to leave at earliest eligibility.

Two major questions are involved in setting the retirement eligibility age. At what age may an employee retire with an immediate annuity? And when may he or she retire with an unredacted annuity?

Currently, the earliest age at which federal employees can retire with an immediate annuity is 55. Employees retiring at that age also receive an unredacted annuity. Age 55 is a common minimum retirement age elsewhere, but except in state and local governments, employers usually reduce annuities between 2 and 6 percent for every year under the more typical retirement age of 62.

An unredacted retirement benefit available at age 55 costs employers twice as much as full retirement at age 65. This is the main reason employers reduce the annuity for those who retire at an early age.

It should be noted that almost all private plans recognize social security as part of the total retirement package. Most employers try to structure a pension benefit which provides a reasonable retirement benefit when added to social security. But social security payments do not begin until age 62, so a pension benefit received at an earlier age often is not adequate for retirement.

Thus, providing a retirement benefit equivalent in value to the one currently available at age 55 may be difficult in the new federal plan.

One way to handle this potential problem is for the government to add a supplemental savings plan to the basic pension. The accumulated money in a savings plan could be used to subsidize early retirement.

Regardless of one's position, setting a new retirement age for a future federal work force will be a very sensitive issue. Concern must be shown for the needs of both the government as employer and of the employees themselves.

Vesting—when an employee becomes entitled to an eventual benefit under a pension plan—is another important issue. It is a particularly vital point to employees who want flexible careers, because a benefit vested after relatively short service is a portable benefit.

Under most defined benefit plans, employees are vested after 10 years on the job. Most defined contribution plans, on the other hand, vest either immediately or after only one year of service.

The early vesting in defined contribution plans contributes to the portable nature of such plans. Early vesting in a defined benefit plan can also help employers recruit late-

career employees. If the rate of benefit accrual is constant with the new employer, an employee would not necessarily be penalized by leaving a former employer late in career.

But early vesting is often a trade-off for other benefits. Because early vesting costs the employer more as a result of vested employees terminating before retirement, benefits to long-term employees may be restrained to compensate.

Adoption of later vesting can foster increased benefits for long-career employees. In short, if long-career employment is desired, later vesting is preferable. If short-career employment is to be encouraged, earlier vesting is best.

Employee contributions to a pension plan are normally used to reduce employer costs, increase the eventual employee benefit and foster a sense of employee involvement in the plan.

Each percent of contribution means approximately a 3 percent addition to the employee's replacement rate of final salary. So employee contributions can significantly increase benefits. But employee contributions do not bolster an employee's legal right to a benefit. Therefore, a larger retirement benefit is the only employee gain from a mandatory contribution system.

The current federal system requires employees to contribute. However, employees in any new plan will have to pay 7 percent and more up to the maximum earnings base to social security.

The great majority of plans in the private sector are non-contributory. Most in state and local government are contributory. This is because most government plans existed before social security. Governments that have restructured their retirement programs in recent years have tended to convert to non-contributory plans.

If a contributory plan is desirable, adding a voluntary supplemental plan to the basic pension may be the best way to go. Offering an optional plan, particularly one where different contribution amounts are allowed, permits employees to individually build for their retirement.

The rate of accrual of benefits can also affect the work force. Accrual of benefits is how each particular year of service is credited for retirement purposes.

For example, the current civil service system credits 1.5 percent of an employee's "high three" years of salary for each of the employees' first five years of service—1.75 percent for each of the next five years and 2 percent for every year thereafter. The retirement benefit cannot exceed 80 percent of the "high three" average, which is reached at 42 years.

This type of benefit accrual is known as "back loading." The civil service retirement system was designed for long-career employees and the back-loaded formula reflects that. Early years of service receive far less benefit accrual than later years, thereby encouraging longer service.

Plans can also be either frontloaded or constant. Some employers may want a youthful work force. If so, the plan's formula would be weighted toward the early years of service. If an employer wants to employ mid- or late-career employees, a front-loaded retirement plan would be an attractive offer.

Finally, the formula can be designed to foster retirements. The Age Discrimination Act generally prohibits mandatory retirement ages, at least outside the government. But many employers circumvent the act by prohibiting further accrual of retirement benefits after age 65. The current system's benefit lid of 80 percent of final salary accomplishes a similar goal.

#### HOW SHOULD NEW SYSTEM INDEX RETIREMENT BENEFITS?

(By James S. Cowen)

Indexation can affect a retirement plan at two different points. The first affects the amount of the initial benefit. The second maintains the real level of the benefit after retirement.

The goal of a good retirement plan is to maintain a career worker's standard of living into retirement. Normally, employees earn their highest incomes in the years just before retirement.

In order to maintain their standard of living, a retirement plan should base its benefits on an average of the salaries of those years.

The problem is cost and accounting. Basing a retirement benefit on a final salary formula is expensive. The fewer years used in the formula, the more expensive the plan.

In addition, private plans must prefund an employee's eventual retirement benefit. A final salary formula requires an employer to project employees' final salaries and to contribute to the pension fund accordingly.

The projections of final salary and other factors required by such a plan are quite variable.

Private industry normally uses the high-

est five years of salary as a formula to determine retirement benefits. A formula using the highest three years of salary costs more.

Indexation after retirement is used to maintain a retiree's real income over time. In industry, retirees are limited to social security increases and company pensions.

Without cost-of-living adjustments, and assuming inflation continues, the standards of living for a retiree will gradually decline.

Indexation of retirement benefits, however, is expensive. It accounts for more than 30 percent of the cost of the civil service benefit.

The current civil service program is one of the few that offers an automatic and fully adjusted COLA. Many employers will grant ad hoc increases when the company is able to provide them.

But employers realize that retirement benefit increases shift income from active workers to retired ones.

Another problem concerns the method of indexation. The few plans that do provide automatic indexing tie the increases to changes in the cost of living.

The most frequently used index is the Consumer Price Index. Many have criticized the CPI as not accurately reflecting the consumption patterns of the elderly. It is argued that the elderly face smaller cost of living increases than those indicated by changes in the CPI.

Full and automatic indexation of the new civil service pension plan will be heatedly debated. One important note is that the social security benefit is fully indexed, thus relieving some pressure on the new pension plan.

Social security provides a survivor benefit to an aged spouse or one with dependent children. The Employee Retirement Income Security Act additionally requires that a pension plan provide a post retirement survivor benefit equal to 50 percent of the worker's benefit.

But a worker may choose no survivor coverage. One who chooses the survivor benefit often finds his retirement benefit reduced by the total projected value of this benefit, which is usually significant.

Private pension plans are not required to provide a pre-retirement survivor benefit except to those workers who are eligible to retire. Thus, few do.

Most firms, however, provide substantial life insurance coverage, which when coupled with social security may be adequate survivor income.

The current civil service plan offers both a pre and post retirement benefit. With social security serving as the base of the new plan, the extent of additional survivor coverage needs to be considered.

Life insurance could act as an adequate supplement of social security, thereby diminishing the need for additional survivor protection. Also, the increasing number of two-worker families reduces the need for such coverage.

On the other hand, young spouses with no dependents are not eligible for social security benefits, possibly creating a need for some further protection.

Disability benefits are meant to provide a level of income to disabled employees. These benefits support employees during their disability but encourage them to attempt rehabilitation and return to work.

The actual amount to accomplish this is difficult to ascertain and varies among income groups. Social security provides fairly good disability benefits, particularly to those with a low income.

In fact, these often exceed current civil service disability benefits.

Rather than provide disability retirement, many employers offer a long term disability insurance program. If an employee becomes disabled, he is placed in such a program with benefits approximating 50 to 60 percent of his pay.

If his disability meets the social security definition, then the firm's benefits are offset by social security benefits to maintain the 50 to 60 percent of pay as total income.

If he fails to become eligible for social security and is not restored to employment, he can usually remain on the disability program for up to two years and is then cut off.

The current civil service plan maintains employees on the disability rolls as long as they continue to meet the civil service definitions. Those with less than 22 years of service, however, are limited to 40 percent of their "high three" years of salary.

The major issues involved in the design of the new civil service retirement are the definition of disability, the amount of the disability benefit, whether the plan's payments should be offset by social security, and whether those failing to meet social security's definition of disability should be cut off.

In addition to social security and a staff retirement plan, most major employers also offer a supplemental plan, such as a thrift plan, salary reduction, stock option or profit sharing. Two government agencies, the Federal Reserve Board and the Tennessee Valley Authority, now offer thrift plans.

The Fed also has a salary reduction plan.

In a thrift plan, an employee's contributions to a savings account are matched by the employer. In a salary reduction plan, the employee sets aside a portion of his pay, deferring some tax liability.

Supplemental plans also are fully portable. Vesting is normally immediate and there are several tax advantages. In any case, supplemental plans can provide a great deal of flexibility to employers and employees in their retirement plans.

#### FUNDING FEDERAL RETIREMENT WITHOUT HIDING COSTS

(By James S. Cowen)

Cost of a pension plan is derived from its benefits, the age of retirements, mortality, turnover, administrative expenses and investment income. A plan's actual cost is equal to benefits paid plus administrative expenses minus investment income.

There are many ways to estimate the cost of a pension plan. Estimates that account for present realities and future probabilities are the most reliable.

The most common method to estimate cost—and the one used by the Board of Actuaries of the civil service system—is termed entry age normal cost.

This method estimates the cost of retirement benefits for a group of newly hired employees, taking into account the plan's benefit formula, wage growth, investment income, price inflation, mortality, turnover, age of retirements and administrative expenses. It reflects a plan's cost as a percentage of current payroll.

For example, the Board of Actuaries has determined the normal cost of the civil service system to be 36 percent of payroll. After the employees' 7 percent contribution, the government must contribute 29 percent of pay to fully fund the total retirement benefits.

But the normal cost method assumes such major economic variables as future wage growth, price inflation and interest income.

If projections for wage growth or price inflation are too low, the system will cost more. If projections for interest are too low, the system will cost less. For instance, holding other things constant, a 1 percent change in the interest component can affect the normal cost by 25 percent.

The Board of Actuaries uses the following economic assumptions to determine normal cost: 6 percent annual interest, 4 percent annual price inflation.

The Social Security Administration uses other sets of economic assumptions for its programs. Its moderate set of assumptions, termed II-B, project 6.1 percent interest, 5.5 percent wage growth and 4 percent inflation.

When these assumptions are used to estimate the cost of the civil service system, the total normal cost is 31 percent rather than 36 percent. The government's cost is 24 percent versus 29 percent.

These estimates do not change the actual cost. They simply provide a measure by which the employer can properly finance the system.

The primary purpose in calculating the cost of a pension system is to determine the funding levels necessary to fulfill the obligations.

Fully funding a system is usually unnecessary. This would entail an employer contributing the total amount required to fund employees' eventual benefits at the beginning of the plan.

Funding a plan as obligations arise, or a "pay as you go system," characterizes the military retirement system. The Internal Revenue Code, however, prohibits a qualified private retirement plan from doing this. Early private plans that did so eventually failed to meet obligations.

The Employee Retirement Income Security Act requires a level of contributions that would, in essence, fund a plan on a normal cost basis. This is one form of partial funding.

ERISA requires a plan to fully fund employees' accrued benefits to assure benefit obligations will be met if a plan is terminated. But because the law provides that other liabilities be amortized over time, accrued benefits usually are not fully funded.

Currently, the civil service system is a partially funded system. If covered by ERISA, however, the system would be deemed underfunded. To comply with ERISA, agencies would be required to fund the normal cost of employees—29 percent of payroll—plus

the government would be required to amortize the civil service system's massive unfunded liability in 30 to 40 years.

One of the most serious issues in designing a new civil service plan will be adequacy of funding.

The civil service retirement fund is part of the unified federal budget. Thus, public monies contributed to the fund become government assets.

The government uses agency contributions and treasury appropriations to buy specially issued government bonds, which are placed in the fund. Because the transaction is from one account to another within the unified budget—treasury to retirement fund—tax or borrowing increases are not necessary to fund the payments. Such an arrangement is really an accounting transaction.

When benefit payments come due, the government redeems the bonds and pays the benefits. At this point, benefits are paid from tax revenues and funds borrowed from the market. Therefore, the first true budgetary effect of the civil service system occurs when retirees get benefits.

This is very different from what occurs in the private sector. ERISA prohibits a company retirement plan from holding more than a small portion of the company's own stocks or bonds. Therefore, the company must generate real money and contribute it to the funding instruments.

In a sense, the company's budget is affected at the point of contribution. The intent of the law is to secure the eventual benefit payments to retirees. If money is held internally by the company and the firm enters financially troubled times, the adequacy of the retirement fund could be jeopardized.

In the federal plan, the retirement fund is required to hold government securities. Since there is little chance of the federal government going bankrupt, financing the retirement plan from the outside is unnecessary for this purpose.

From a pure budgetary standpoint, there is no need to prefund a new government retirement plan, since the timing of the funding has no impact on the budget or the health of the system.

As long as a new government plan holds only government securities, the budgetary cost in the beginning will be minimal but will increase over time regardless of its funding adequacy. On the other hand, without adequate prefunding, the true cost of a new plan could be hidden until later years, causing backlash now experienced by the civil service system.

Therefore, a new plan should provide for funding methods that the federal government requires of private plans. If funds are to remain within the government, the budgetary impact will remain the same—at the point of benefit distribution.

But the true annual cost to the public will always be known. The recognition of the full cost of a new plan, accompanied by adequate funding, should go a long way to the plan's public acceptance.

#### HOW PRIVATE INVESTMENTS COULD CHANGE RETIREMENT

(By James S. Cowen)

What are the benefits and drawbacks—from the government's and employee's perspectives—of investing pension funds outside the federal government? And what are the economic implications of such a change?

Currently, funds of the civil service system are invested solely in government securities. Although the interest earnings have no budgetary effect, they do have a positive impact on the accounting solvency of the retirement fund.

If a portion of the new civil service retirement fund is held outside the government and earnings exceed current earnings, the cost of the new plan eventually could be substantially reduced without necessarily affecting benefit levels.

The determinant is called the real rate of return on investments. This is the interest earned over inflation.

The Board of Actuaries of the civil service system estimates the current fund in the long run will earn a 1 percent real rate of return. Long-term rates of return in the private sector, however, have traditionally exceeded this figure.

Thirty and 50 year historical averages show Treasury bill returns barely exceeding inflation, with more mixed investment port-

folios of stocks and bonds earning 2 to 3 percent real rates of return.

This can have a dramatic impact on a pension fund. Costs can be reduced in a defined benefit plan or benefits will increase in a defined contribution plan.

Investing solely in government securities can be justified on two counts. One, the government as employer completely controls the money at no risk to itself or to the fund. Two, real money is not needed until benefit payments become due many years after the establishment of the plan.

It should be noted, however, that almost all other pension funds invest outside the employer's entity, including state and local governments to which such investments are optional. The two federal government thrift plans, at the Federal Reserve Board and the Tennessee Valley Authority, invest in a variety of instruments.

In other words, employers have found outside investments beneficial to their pension plans, regardless of the increased risk.

While internally held funds reduce costs in the earlier years, they make no difference in the eventual cost. The primary impact of private investment of a new pension plan would be a short-term federal budget phenomenon.

Real money contributions would be made which, when coupled with benefit payments from the current program, would increase government spending at least for the near term. But the question becomes: What real impact would be felt on financial markets?

Presumably, the Treasury would borrow additional monies from private markets to make the contributions.

Generally, government intrusion into the market increases interest rates because of increased demand on a constant supply of money. In this case, however, the money is returning to the market in the form of long-term investments. So in essence, the same money is borrowed and then recycled back into investments, not altering the total capital available in the markets.

In defined contribution plans or thrift plans, private investment can provide opportunities for employees to become more involved in their own retirement planning. Often these plans grant employees investment options in which they can designate a certain percentage of contributions to specific funds such as stocks, bonds or real estate.

It has been shown that investment needs vary not only among individual employees but also among different age groups. Thus these arrangements could enhance career and retirement flexibility.

Private investment of a government plan also raises the possibility of governmental interference in investment decisions. Stringent safeguards would have to be applied to assure that investments were made solely for the benefit of the participants. An independent board would have to oversee such an arrangement.

Again, though, most state and local government plans and the two federal thrift plans similarly invest in private concerns and are subject to the same potential conflicts a new civil service plan would experience. Adequate protection can be afforded, but it is impossible to absolutely prevent abuse. The risk would always exist.

Questions could be raised as to whether financial markets could absorb such a large infusion of new capital. This is not a serious problem.

The nation's largest 1000 pension funds currently hold more than \$750 billion in assets. Total contributions to the new plan will be fairly low in the early years due to its coverage of a relatively few number of people. As the plan's coverage and contributions grow, other funds will similarly grow.

Besides, other large states and corporations have substantial pension funds which do not overwhelm the capital markets.

Finally, a private investment feature in a new plan has the potential of assisting in capital formation. Monies now used solely for benefit payments would be first invested in long-term securities providing additional capital to business.

Private investment of funds by a new civil service plan would be a major break from historical practice, but it should be considered. Such an initiative, however, should be approached carefully.